### Statement of Christopher Cox

on behalf of

# **NetChoice**

## Testimony before the

United States House of Representatives Committee on the Judiciary

Hearing on:

Exploring Alternative Solutions on the Internet Sales Tax Issue

March 12, 2014

Thank you for holding a hearing on *Exploring Alternative Solutions on the Internet Sales*Tax Issue. As you know, I have worked with many of you on this Committee on Internet

Chairman Goodlatte, Ranking Member Conyers, and members of the Committee:

legislation over the last 20 years, and in particular the Internet Tax Freedom Act, which I co-authored with Sen. Ron Wyden in 1998.

I serve as tax policy advisor to NetChoice, a coalition of leading e-commerce and online companies promoting the value, convenience, and choice of Internet business models.

NetChoice has been deeply engaged on Internet tax issues for 14 years, including testimony before this committee and policy debates in the Wall Street Journal, on CNBC, CSPAN, CNN, and PBS. Since 2004, we have participated in meetings of the Streamlined Sales Tax Project (SSTP), a long-term effort to simplify state sales tax systems in response to the *Quill* ruling of the U.S. Supreme Court.

NetChoice is a founding member of TruST, the coalition for True Simplification of Taxation (www.TrueSimplification.org), a group whose association members also include the American Catalog Mailers Association, the Direct Marketing Association, and the Electronic Retailing Association. Coalition members submitted written statements for today's hearing, and we respectfully ask that their statements be included as part of the hearing record.

The yardstick for measuring the strength or weakness of various approaches to taxing remote transactions on the Internet must be the *Basic Principles on Remote Sales Taxes* put forth by this Committee. We fully support these common-sense Principles, which are necessary to guarantee fundamental fairness to all marketplace participants. This hearing is focused on exploring alternatives to the Senate-passed Marketplace Fairness Act (MFA), and it should be clearly stated before moving to discussion of those alternatives that the MFA itself fails to satisfy any of the Principles. Achieving every one of the Principles is a challenge even when one starts from a blank slate. Attempting to contort and stretch the pre-conceived MFA approach to fit the Principles is an undertaking worthy of Procrustes. But is ultimately impossible.

If one begins with the Principles as the blueprint, the task – while still difficult – becomes more rational. The Principles themselves suggest the way forward. Building on the fundamental concepts in the Principles, we have conceptualized an alternative to the fundamentally flawed MFA that enables states to collect sales tax on remote transactions. This approach, best described as *Home Rule & Revenue Return*, has three main characteristics:

- 1. **Fairness**. Unlike the MFA, our alternative imposes the same tax compliance burdens on all retailers, whether brick-and-mortar, online, or catalog.
- 2. **Simplicity.** In contrast to the complexity and costs created by MFA that requires expensive and potentially flawed software integration, our alternative is workable for the smallest of businesses. Brick-and-mortar and e-businesses alike, no matter their size, would use the tax rates and rules of their home state—just like they do today.
- 3. **States' Rights.** Serious constitutional problems arise when states attempt to impose tax collection and compliance burdens on out-of-state businesses. This is the central design flaw of the MFA. Our proposed alternative is built on the constitutional principle that each state is sovereign over the regulation and taxation of businesses in that state. Each state will have the choice whether to join a multi-state compact, pursuant to which taxes on out-of-state sales would be collected.

The Judiciary Committee has a unique role, given your responsibilities to protect interstate commerce, and to protect states' rights to make their own tax policies within a federal system. Successfully achieving both of these objectives is central to resolving the debate over Internet sales tax collection. To understand how these potentially conflicting objectives can be reconciled begins with the answers to three key questions:

- Why don't online and catalog retailers pay sales tax to every state?
- Haven't states simplified their sales tax systems through the SSTP initiative?
- Isn't this debate fundamentally about "fairness"?

#### Why don't online and catalog retailers pay sales tax to every state?

The editors of the *Wall Street Journal* asked NetChoice to provide the opposing side in a debate over internet sales tax. Our published article began with this question and answer:

Should online retailers have to collect sales tax?

**Yes, and they already do.** Just like all retailers, online stores must collect sales tax for every state where they have a physical presence. That's why Amazon.com adds sales tax to orders from customers in the 5 states where it has facilities. But Amazon and online retailers aren't required to collect tax for other states, leaving those customers to pay a "use tax" that states rarely enforce against individual taxpayers. This framework frustrates state tax collectors and businesses that compete with online retailers. But when we learn how this

physical presence requirement evolved, it becomes clear why we should retain this standard for imposing new tax collection burdens on online retailers. 1

As members of this Committee know, today's physical presence standard is based on Article I of the Constitution. It is designed for the very purpose of preventing individual states from impeding commerce among the states. The Commerce Clause was necessary to restrain states that had been imposing taxes, duties, and other trade barriers on each other in ways that favored in-state businesses and unfairly burdened out-of-state businesses. It is just as necessary now as it was when written.

During the 1960s, some state tax collectors attempted to force out-of-state catalog retailers to collect in-state sales taxes. The U.S. Supreme Court, relying on the Commerce Clause, held that states cannot impose taxes on out-of-state businesses "whose only connection with customers in the State is by common carrier or the United States mail."<sup>2</sup>

In 1992, the Supreme Court revisited the issue of remote taxation, this time in the case of an office products catalog seller, Quill. In Quill, the Supreme Court was not moved by the state's argument that computer technology created the necessary simplification. While acknowledging the lower court's finding that advances in computer technology had eased the burdens of tax collection, the Court still found the requirement of tax collection unduly burdensome.<sup>4</sup> Observing the patchwork of rates and rules for several thousand sales tax jurisdictions, the



Court again held that requiring out-of-state companies to pay sales taxes would place an unreasonable burden on interstate commerce. <sup>5</sup>

<sup>4</sup> *Id.* at 313.

<sup>&</sup>lt;sup>1</sup> Steve DelBianco, Should States Require Online Retailers To Collect Sales Tax?, Wall Street Journal (Nov 14, 2011).

<sup>&</sup>lt;sup>2</sup> Nat'l Bellas Hess, Inc. v. Dept. of Rev. of Ill., 386 U. S. 753, 758 (1967).

<sup>&</sup>lt;sup>3</sup> Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

<sup>&</sup>lt;sup>5</sup> Moreover, Quill was not concerned with "fairness" to individual tax collecting states, as some have argued, but with the burden on interstate commerce that results from multiple tax collection and compliance burdens. "[T]he Commerce Clause and its nexus requirement," the Court said, "are informed

Quill has served to protect local businesses that maintain websites from overbearing tax compliance burdens imposed by scores of foreign states where the business has no physical presence. At the same time, it requires every business, large or small, to collect and report sales tax in the same way in every state where the business does have a physical presence.

Understanding why the Quill standard exists – to protect local businesses engaged in out-of-state commerce from the burdens of multiple and discriminatory taxation - is essential to the consideration of any alternative approach.

#### Haven't states simplified their sales tax systems through their SSTP initiative?

In 1998 when Congress enacted, and President Bill Clinton signed, the Internet Tax Freedom Act, we deliberately chose not to exercise the legislative power under the so-called "dormant Commerce Clause" to authorize the states to impose their sales tax collection and compliance burdens on out-of-state retailers. Instead, the law established a Commission to study those and related issues. The transmittal of the final report of the Advisory Commission on Electronic Commerce in April 2000 recommended to Congress as follows:

"Place the burden on states to simplify their own labyrinthine telecommunications tax systems as well as sales and use tax systems to ease burdens on interstate commerce. Radical simplification will be necessary in the New Economy if small and medium-sized businesses are to succeed."6

Thus began the effort that became the Streamlined Sales Tax Project (SSTP). Several individuals who were members of the Advisory Commission supported the effort. Its purpose was to create a sufficiently simple nationwide system of sales and use tax rules, definitions, audit authorities, filing requirements, and compliance regimes that could persuade Congress to exercise its power under the dormant Commerce Clause. The idea was that a simple one-sizefits-all system of uniform sales tax rules would remove the burden of what the Supreme Court called "a virtual welter of complicated obligations," inspiring Congress to authorize each state to force its tax compliance obligations on sellers in every other state.

not so much by concerns about fairness for the individual [state] as by structural concerns about the effects of state regulation on the national economy."

<sup>&</sup>lt;sup>6</sup> Letter to Congress from Advisory Commission on Electronic Commerce (Apr. 2000) (emphasis added).

<sup>&</sup>lt;sup>7</sup> See Quill, supra, n.3.

NetChoice has long been a supporter of the effort to streamline and simplify state sales taxes. But thus far, the SSTP has failed to come even close to its stated objective. Despite a decade of trying, the actual simplifications achieved by the SSTP are few -- and not nearly sufficient to justify Congress abandoning its role in protecting interstate commerce.

Unfortunately, for the SSTP simplification has become just a slogan – not a standard.

The SSTP originally sought one tax rate per state, which would represent true simplification. Too many states were unwilling to do this, so the SSTP



simply abandoned the effort. The SSTP's "simplification" now accommodates over 9,600 local jurisdictions, each with its own tax rates and sales tax holidays. That is actually a substantial *increase* from the 7,800 jurisdictions that existed at the time of *Quill*. And the number is still growing, making the U.S. a true outlier. The European Union has only 27 jurisdictions for its Value Added Tax (VAT). India lets each state have but a single tax rate. We are the only country in the world in which sales taxes on national commerce are allowed to proliferate at the local government level.

The SSTP has abandoned too many of its original simplification requirements. For example, the SSTP no longer requires that retailers be compensated by foreign states for the cost of out-of-state compliance. It has all but eliminated the small seller exception. In an effort to attract states with origin sourcing, the SSTP abandoned a single sourcing rule and now allows for multiple sourcing schemes. To entice Massachusetts to join SSTP, the Governing Board allowed thresholds for certain clothing items, even though thresholds were one of the extreme complexities its founders pledged to eliminate.

Perhaps the most glaring sign of failure is that despite the SSTP's many concessions to each state's desired exceptions from the rule of simplicity, less than half of eligible states have joined. Today, the majority of states are not members of the Streamlined Sales and Use Tax Agreement (SSUTA). (There are only 22 full member states in the SSUTA).

and use tax rates per year.").

<sup>8 &</sup>quot;Vertex Press Release (Mar. 21, 2012), available at http://www.vertexinc.com/pressroom/PDF/2012/vertex-address-cleansing.pdf ("At the end of 2011, there were over 9,600 taxing jurisdictions across the U.S. with an average of 651 new and changed sales

#### Isn't this debate fundamentally about "fairness"?

Yes.

The seven elements in this Committee's *Basic Principles on Remote Sales Taxes* all ultimately relate to fairness to the many stakeholders in this debate. The Committee's cardinal Principle, the first of the seven, is "Tax Relief" – in recognition of the fact that the interests of individual citizens are paramount to those of state governments and businesses. Under this heading the Committee has also warned against placing discriminatory tax compliance burdens on Internet retailers that brick-and-mortar businesses do not bear in the offline world.

The second Principle, "Tech Neutrality," is about horizontal equity. Brick-and-mortar, ecommerce, and "brick-and-click" businesses should all be on equal footing. Under this heading, the Committee explicitly states that tax *compliance* burdens should not be greater for any category of business.

The third Principle, "No Regulation Without Representation," recognizes that fairness dictates that those who would bear the tax, regulatory, and compliance burdens of a state should have the rights every citizen deserves to protest against unfairness in the imposition of those burdens. Citizens of a state have such recourse against their government, but out-of-state businesses normally do not.

The fourth Principle, "Simplicity," is aimed at ensuring fairness in state governments' treatment of small business. The Committee has recognized that when governments place onerous compliance requirements on businesses, the large ones can more easily comply than the small ones, which gives big business an unfair advantage. In this way the complexity of MFA discriminates against small business.

The fifth Principle is also about fairness to individual taxpayers. "Tax Competition," which exists when state governments are required to bear the costs as well as reap the benefits of high-tax policies, helps consumers.

The penultimate Principal, "States' Rights," is about fairness to each state government. In enunciating this Principle, the Committee recognized that no state can exercise its sovereignty beyond its borders without intruding on the sovereign prerogatives of another state. The Committee explicitly noted that were the federal government to mandate that states impose sales tax compliance burdens on out-of-state sellers, this principle of fairness to every state would be violated.

The final Principle, like all the others, is also focused on fairness. "Privacy Rights" must be at the forefront of any discussion of remote sales tax collection, because robbing consumers of their privacy in the name of tax collection is fundamentally unfair. Proposals to enforce a state's sales tax regime that entail keeping computer records of what each of us buys fail to satisfy this critical principle.

The existing system of sales tax collection fairly meets every one of the Principles -- with one exception. Similarly situated businesses do not collect taxes from out-of-state purchasers in the same way. But already today, *all* retailers -- large and small, brick-and-mortar, and e-commerce alike -- *do* collect sales tax in every state where that business is located. The current "physical presence" standard protects all businesses, large and small, from the unreasonable compliance burdens they would face if forced to collect for thousands of state and local tax jurisdictions within the United States. If this protective standard is to be changed in order to ensure that all businesses collect taxes from out-of-state purchasers, it must be accomplished in such a way that maintains this protection.

Even now, not only Internet retailers but brick-and-mortar retailers are protected by the physical presence standard. This standard guarantees that both brick-and-mortar and Internet businesses do not have to assume the burden of complying with the tax rules of all the states of residence of every one of their customers.

Imagine if a retail store on Main Street, which today collects sales tax for just the one jurisdiction where it is located, were required to collect and file tax according to the rules of the states of every one of its customers. Here's how NetChoice put it when the editors of *USA Today* invited us to give our view on MFA:

Imagine if the cashiers handling your Black Friday checkouts asked to see your driver's license so they could look up sales tax rates and rules for the town where you live, then file returns and face tax audits for every state their customers came from. That sounds crazy, but it's exactly what the latest Internet sales tax bill would require for any business that sells through a catalog or website. 9

Fundamental fairness is not just a good idea; it is a bedrock Constitutional principle. It is the basic test of due process. For this reason, proposals for states to exert their regulatory and

<sup>&</sup>lt;sup>9</sup> Steve DelBianco, *Internet sales tax would level start-ups: Opposing view,* USA Today (Nov 28, 2013).

tax powers over out-of-state small businesses are not just bad ideas, but potentially unconstitutional.

The very same Supreme Court decision that confirmed the current "physical presence" standard under the Commerce Clause, *Quill Corp. v. North Dakota*, also held that a state's ability to impose tax collection burdens on an out-of-state business must comply with the Due Process Clause. That is because, the Court said, the Commerce Clause and the Due Process Clause "pose distinct limits on the taxing powers of the States." Moreover, "the two constitutional requirements differ fundamentally," because they "reflect different constitutional concerns."

While the Commerce Clause test is a bright line – does the business have a physical presence in the state? – the Due Process test is one of fundamental fairness. Are the business's contacts with a foreign state deep enough and substantial enough so that it would be fair to expect the owner of the business to have to personally appear in court in the foreign state? Quill makes it clear that if a state can require an out-of-state seller to collect its taxes and comply with its tax laws, it can also make that person appear in its courts to defend against lawsuits in that state. The Due Process test first set out in *International Shoe Co. v.*Washington 10 is the same for taxation, regulation, and personal jurisdiction.

Most would agree it is fundamentally unfair to force a local retailer, with only one place of business in a single state, to be subject to tax compliance burdens, including the requirement to appear in person to defend a lawsuit, in each of the 46 states that have sales taxes. If the same local retailer with only one place of business has a website, does this change the analysis?

Any small business that has a website is perforce exposed to the entire world. If the small business, let us say a bookseller, receives an order from a customer in North Dakota -- or even from a customer in Japan -- should fulfilling the order automatically subject it to direct regulation and taxation by that foreign government? Should this automatically make it subject to the regulation, taxation, and judicial reach of every U.S. jurisdiction?

It is virtually impossible for the bookseller in Vermont to have a website that is accessible everywhere except, say, North Dakota. Should the owner of a that small business in Vermont be required to refuse all Web sales from North Dakota, or else automatically be required to travel to North Dakota when commanded by that state to do so? That is the due

<sup>&</sup>lt;sup>10</sup> Int'l Shoe Co. v. Washington, 326 U.S. 310 (1945).

process question posed by the MFA and similar schemes. The Supreme Court in *Quill* effectively has answered it. To subject itself to the tax and regulatory jurisdiction of another state, a business must engage in "continuous and widespread solicitation of business" there. Only then will a business have "fair warning" that its activities will subject it "to the jurisdiction of a foreign sovereign."

Mere maintenance of a website hardly amounts to "continuous and widespread solicitation." To argue that it does would require one to deem it "fair" for every business with a website to be regulated by every jurisdiction on Earth with access to the worldwide web. That is why, as former Solicitor General Paul Clement has written, "due process problems are particularly likely with respect to taxation of online sales." As he explains, "when a seller offers an item for sale on a website, customers from all 50 states may purchase that item — whether or not the retailer takes conscious steps to target consumers from all 50 states." In the case of the local business that maintains a website, he wrote, "a court would likely find a due process violation" if a distant state sought to tax isolated transactions there. <sup>12</sup>

Today's approach to the taxation of Internet sales is consistent with due process. All retailers collect sales tax for every state where they choose to have a physical presence.

Because a business can choose whether to open a store or send sales representatives to another state, it can be fairly said that the business has elected to subject itself to that state's laws, including those governing sales taxes. In return, the business can take advantage of state-provided benefits including roads and infrastructure, police and fire protection, utilities, etc...

Today, large national retail chains and big-box stores have retail outlets or distribution centers in almost every state, along with websites that let online customers arrange pickups and returns at their local stores. These businesses use many local public services wherever they have stores, and thereby reap benefits that out-of-state retailers do not. In return, these large, nationally active businesses are required to collect sales tax in the states where they are

<sup>&</sup>lt;sup>11</sup> Quill, supra, at 308 note 3.

Quill, supra, at 308 note 3

located. The out-of-state online retailers do not use local public services, and they do not have to collect sales taxes because they have no physical presence. This is fundamentally fair. <sup>13</sup>

Today, Amazon is adding distribution centers to enable faster delivery to customers around the country, which will require Amazon to collect sales tax *for two-thirds of all Americans by 2016*. <sup>14</sup> Like the big-box stores, Amazon would cut its tax compliance costs if states adopted even tiny steps toward simplification. More important, Amazon wins if MFA forces more small businesses to move their online sales onto Amazon's platform, where Amazon charges a 3% fee to collect sales tax, Amazon keeps up to 15% of every sales dollar, and Amazon sees 100% of the data on customer searches and purchases.

#### Other Constitutional Concerns with MFA and SSTP

In addition to the due process concerns raised by the MFA, the Senate-passed bill suffers from two other significant constitutional infirmities. First, the SSUTA is not an approvable interstate compact under the Compact Clause. Second, the MFA purports to delegate significant federal power to the Governing Board of the SSTP, in violation of the Appointments Clause. 16

The Compact Clause and its constitutional complement, the State Treaty Clause, <sup>17</sup> together ensure that a minority of states cannot band together to make national policy that directly affects all states. Interstate compacts are permissible where they treat discrete regional issues, such as boundary disputes, that directly affect the compacting states but not all others; but such compacts require congressional approval. On the other hand, purported state alliances that are national in scope and treat ongoing issues cannot be the subject of a

<sup>&</sup>lt;sup>13</sup> In *Quill*, the Supreme Court expressly considered and rejected the argument that it is unfair to give out-of-state sellers "a significant competitive advantage over local retailers" by permitting them to be exempt from foreign state sales tax collection burdens. *Quill*, *supra*, at 304 n. 2. The Court obviously believed it of greatest importance to protect both in-state and out-of-state businesses equally from unfair burdens imposed by foreign jurisdictions.

<sup>&</sup>lt;sup>14</sup> States where Amazon is now (or scheduled) to collect sales tax: AZ, CA, CT, FL (2016), GA, IN, KS, KY, MA, ND, NJ, NV, NY, PA, SC (2016), TN, TX, VA, WA, WI, WV

<sup>&</sup>lt;sup>15</sup> U.S. CONST. art. I, §10, cl. 3.

<sup>&</sup>lt;sup>16</sup> U.S. CONST. art. II, §2.

<sup>&</sup>lt;sup>17</sup> U.S. CONST. art. I, §10, cl. 1 prohibits states from entering into a "Treaty, Alliance, or Confederation" – even with congressional approval.

"compact," but rather would constitute an impermissible "treaty, alliance, or confederation." The Constitution plainly forbids such arrangements among states. In contrast to interstate compacts, which may be given validity if Congress approves, the Constitution pointedly withholds from Congress the authority to approve such forbidden multistate alliances.

MFA by its terms purports to delegate to the SSTP Governing Board the ongoing authority to exercise federal power throughout the United States. In particular, MFA effectively gives the Governing Board *carte blanche* to prescribe and to change tax rules for member states on an ongoing basis. Moreover, under MFA, a state's membership in the SSTP gives that state the power to impose tax collection burdens and audit sellers in every other state. This power would extend even to states that do not join the SSTP. Even if this authority were exercised only in member states, its impact would clearly be national in scope, and its exercise would be continuous.

This indefinite and ongoing power to interpret and redefine the SSUTA, which MFA delegates to the SSTP's Governing Board, is the reason the arrangement also violates the Appointments Clause. <sup>19</sup> Under the Appointments Clause, only those officers of the United States properly appointed within the executive or judicial branches can "exercise[e] significant authority pursuant to the laws of the United States." <sup>20</sup> But under MFA, the SSTP Governing Board, consisting of officials appointed not by the President but by member states, would wield extensive influence throughout the nation. Specifically, MFA would delegate to these individuals (who by definition are not duly appointed "officers of the United States") the uniquely federal power to decide when and under what circumstances SSTP member states would be authorized to engage in activity otherwise in violation of the Commerce Clause. The Governing Board could decide which states may tax remote sales, promulgate rules governing inter-state sales and use taxation, and interpret what is and is not subject tax. Such an

-

As noted in Paul Clement, Patricia Maher, and Zachary Tripp, Constitutional Difficulties of Proposed Streamlined Sales Tax Legislation (King & Spaulding, Oct. 2009), p. 1 (accessible at <a href="http://netchoice.org/clement2">http://netchoice.org/clement2</a>), "The Framers understood the Compact Clause to play a limited role relating to the resolution of regional disputes, not to be a mechanism by which a minority of states could make and execute national policy."

<sup>&</sup>lt;sup>19</sup> U.S. CONST. art. II, §2, cl. 2.

<sup>&</sup>lt;sup>20</sup> Buckley v. Valeo, 424 U.S. 1, 126 (1976).

arrangement would amount to Congress handing over to the Governing Board "the keys to the Commerce Clause itself." <sup>21</sup>

#### **Principles to Guide Congressional Action**

A first principle in drafting legislation, just as in medicine, is "do no harm." Today's system of sales taxation is fundamentally fair to interstate commerce and to all stakeholders, because brick-and-mortar, brick-and-click, and e-commerce businesses alike are protected from unfair out-of-state tax compliance burdens. When a customer walks into a hardware store in Tucson, the clerk does not ask what state and county the customer lives in, so the clerk may compute sales tax accordingly. Instead, the Tucson clerk always charges the local tax rate, no matter where the customer lives. In this way, the brick-and-mortar business is protected from having to comply with the tax laws and filing requirements of 46 other states. This is the same protection that an e-commerce business enjoys.

It is important to note that this is the exception, not the rule. Even without any change in federal law, most sales taxes on e-commerce are already being collected. As of 2013, 17 of the top 20 e-retailers were *already* collecting sales taxes in at least 38 of the 46 sales tax states. It has been publicly reported that within two years, Amazon will have physical presence in states that are home to two-thirds of all Americans. With no change in federal law, therefore, the lion's share of sales tax from Internet retail is already being collected.

It is also important to note that the competitive threat to brick-and-mortar retail from ecommerce comes largely from factors other than sales taxes. There is abundant evidence for why people shop online and through catalogs: they are looking for convenience, selection, and lower prices. Indeed, there is no persuasive data showing that avoidance of sales tax is a principal motivation of online and catalog shoppers. To the contrary, all the evidence suggests that shoppers seek a good value by comparing prices *before* tax is added at checkout.

Moreover, shipping and handling charges for remote sales frequently exceed any sales tax avoided. Finally, Amazon posted impressive year-over-year sales gains in 2013 in states where it *added* sales tax collection for its customers.

-

<sup>&</sup>lt;sup>21</sup> Clement, Maher, and Tripp, *supra*, at 15.

Still, there is a deeply held belief that current law is unfair to brick-and-mortar stores. If Congress is committed to overrule the Supreme Court's decision in *Quill* in pursuit of fairness and tax revenue, it must do so with great caution so as to maintain the current protections against out-of-state regulation and taxation that are enjoyed broadly by all retailers. My testimony on how this Committee might find a better way than MFA should be understood in this vein.

Once resolved to "first, do no harm," this Committee can do no better than to follow the *Basic Principles on Remote Sales Taxes* that Chairman Goodlatte has announced. NetChoice supports these Principles entirely, and appreciates the specific explanations and contextual meanings provided for such essential terms as fairness, simplicity, and states' rights.

As a first step, it is useful to compare the Principles to the MFA as it passed the Senate in March 2013. As will be seen in the table below, the MFA fails across the board to achieve the objectives of the Principles.

Judiciary Committee Principles	Marketplace Fairness Act of 2013
1. Tax Relief – Using the Internet should not create new or discriminatory taxes not faced in the offline world. No fresh precedent for other areas of interstate taxation by States.	MFA Fails. Only businesses selling online or via catalog would face new requirements to collect taxes based on where the purchaser lives, as well as compliance and audit demands from 46 states – each with its own rates and rules.
2. Tech Neutrality – The tax compliance burden on online sellers should not be less, but neither should it be greater than for similarly situated offline businesses.	MFA Fails. MFA forces internet and catalog sellers to file in and comply with the differing rules of 46 states – plus up to 550 Indian tribes in the Senate-passed version. Brick-and-mortar businesses would comply only with the rules of the states where they are located.
<b>3. No Regulation Without Representation</b> – Those who would bear state taxation, regulation and compliance burdens should have direct recourse to protest unfair, unwise or discriminatory rates and enforcement.	MFA Fails. There is no recourse for Internet sellers when out-of-state tax authorities make unreasonable demands for taxes, paperwork, and audits. Internet sellers must travel to foreign states and face foreign courts.
<b>4. Simplicity</b> – So simple and compliance so inexpensive and reliable as to render a small business exemption unnecessary.	MFA Fails. States were not required to have common rules and definitions. Lacking true simplification, and offering no help with software integration, MFA purports to exempt small businesses but fails even to do that.
<b>5. Tax Competition</b> – Governments should be encouraged to compete to keep tax rates low and American businesses should not be disadvantaged vis-a-vis foreign competitors.	MFA Fails. States were not required to have common rules and definitions. Lacking true simplification, and offering no help with software integration, MFA purports to exempt small businesses but fails even to do that.
<b>6. States' Rights</b> – States should be sovereign within their physical boundaries. Congress should not mandate that States impose any sales tax compliance burdens.	MFA Fails. MFA gives new tax and audit powers to every state, allowing them to reach across their borders. This threatens the sovereignty of every other state. Other states would not be able to opt out of MFA; rather Congress would mandate their submission to other states' business activity taxes and regulations.
7. Privacy Rights – Sensitive customer data must be protected.	MFA Fails. MFA has no privacy protections whatsoever. Worse, it incentivizes out-of-state tax collectors to demand customer information from retailers.

The most significant reason that MFA fails all seven of the Principles is that it would force catalog and Internet sellers to incur significant new tax compliance costs that are not borne by brick-and-mortar retailers. Instead of leveling the playing field, MFA would heavily discriminate against e-commerce. Under MFA, brick-and-mortar stores would not have to

comply with out-of-state tax rules where they have no physical presence, but e-commerce stores would. Moreover, because these costs are disproportionately expensive for small businesses, the small e-commerce firms would be hardest hit.

The SSTP's own Cost of Collection<sup>22</sup> study found that the smallest businesses spend 17 cents for every tax dollar they collect for states. That is vastly more than their large-scale competitors. Even if the "free" tax software were to work as advertised (and as explained later, it will not), that would help eliminate only two cents of the extra costs. So a small business with annual revenues of \$1 million would still incur a new cost burden equal to 15 cents on every dollar it collects, for tasks such as:

- Computer consultants to integrate new tax software into their home-grown or customized systems for point-of-sale, web shopping cart, fulfillment, and accounting
- Training customer support and back-office staff
- Answering customer questions about entity and use exemptions and sales tax holidays
- Responding to audit demands from 46 states plus up to 550 Indian Tribes, per S.743
- Accountants and IT consultants to help with all of the above

These collection burdens will impose impossibly high costs on small catalog and online businesses. Ask any small business – a brick-and-mortar store on Main Street, or an online store – and you'll hear it's hard enough to collect sales tax for one state. It would be a nightmare for a small business to have to comply with the rules of all 46 states, each with sales tax rates, regulations, and unique filing burdens of its own.

The most significant of these costs is the expense of integrating tax rate lookup software into the business's in-house information systems. The cost is high not only because the software integration requires specialized skills, but also because it must be done at multiple integration points. Last year, the True Simplification of Taxation (TruST) coalition commissioned a study to precisely measure both the upfront and ongoing software integration costs. The study examined both catalog and online retailers in the mid-market bracket (\$5 - \$50 million in annual sales). The study found that such mid-market online and catalog retailers would have

-

<sup>&</sup>lt;sup>22</sup> Available at http://www.netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf.

<sup>&</sup>lt;sup>23</sup> Larry Kavanagh and Al Bessin, *The Real-World Challenges in Collecting Multi-State Sales Tax*, September 2013.

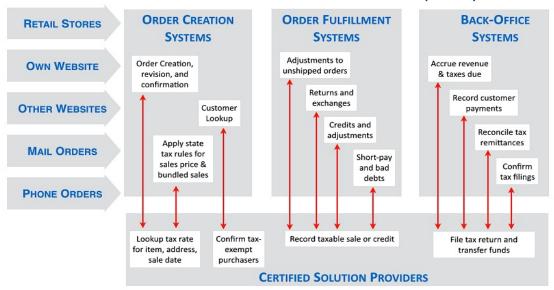
to spend \$80,000 to \$290,000 in setup and integration costs in order to use the so-called "free" software promised by advocates of the MFA.

Beyond the average \$185,000 initial cost, every year these retailers would also have to spend between \$57,500 and \$260,000 on maintenance, updates, audits, and service fees charged by software providers. These findings explode the myth of plug-and-play integration:

Most mid-market retailers have modified third party order management software to fit their business processes or have developed their own software. They use these order management systems for call center order entry, customer service, returns and refund processing, inventory management and more. In many cases, these systems also integrate to separate accounting systems. In order to integrate with a CSP [Certified Software Provider], the retailer must make architectural modifications to map to the coding system of the CSP, establish real-time communication, and create protocols to handle transactions when the real-time service fails to return a valid reply.

For a visual explanation of the software integration challenges, see the diagram below:

# Integrating Online & Catalog Retailer Systems with Certified Solution Providers(CSP)



MFA's carve-out for small business does not begin to address this problem. The exemption of businesses with up to \$1 million in annual remote sales still leaves many very small firms unprotected from the outsized new costs and burdens that MFA would impose. A company with \$1 million in sales over a 12-month period is typically just a one or two person

business. As NetChoice has explained in previous testimony, an exemption of at least \$15 million in annual sales would be needed to achieve the intended purpose of protecting small businesses whose scale would not permit them to absorb MFA's exorbitant costs. <sup>24</sup>

A recent study claiming that a \$1 million small business exemption would protect all but about 1,000 online businesses from MFA is grossly inaccurate. The study commissioned by the U.S. Small Business Administration (SBA),<sup>25</sup> inexplicably chose to rely upon the same University of Tennessee professors who admitted their earlier estimate of uncollected sales tax, overstated by 70%.<sup>26</sup> In the SBA November 2013 report, the professors advance the demonstrably false assertion that MFA would affect only 974 online sellers.

There are several reasons this estimate should not be relied upon when considering legislation. First, the authors heavily rely on calculations from a 2008 study that found that there were in fact 28,628 online sellers with sales over \$1 million<sup>27</sup> -- significantly more than the 974 found by the SBA study. Second, the SBA study's authors based their study on the patently false assumption that *anyone* who *ever* sold any item on eBay is an online business.<sup>28</sup> This became the basis for their claim that "99% of online businesses are less than \$1 million." It is preposterous to include an individual who sells a used bicycle on eBay, Craigslist, or a newspaper classified ad web page within the definition of "online businesses." Third, the study relied on the *Internet Retailer Top 1000* to identify the universe of online sellers with over \$1 million in sales, even though that publication explains that its listing of websites in the top 1,000 is based *solely on web traffic*.<sup>29</sup> This definition does not even purport to be a fair proxy for online sellers with more than \$1 million in revenue. A few examples will quickly illustrate:

<sup>&</sup>lt;sup>24</sup> NetChoice Testimony for House Judiciary hearing, H.R. 3179, the "Marketplace Equity Act of 2011" (July 7, 2012)

<sup>&</sup>lt;sup>25</sup> Bruce & Fox, An Analysis of Internet Sales Taxation and the Small Seller Exemption, Nov. 2013

<sup>&</sup>lt;sup>26</sup> See, Donald Bruce, William F. Fox, & LeAnn Luna, State and Local Government Sales Tax Revenue Losses from Electronic Commerce, University of Tennessee Working Paper (Apr. 13, 2009), Donald Bruce & William F. Fox, State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates, University of Tennessee (Sept. 2001)

<sup>&</sup>lt;sup>27</sup> Bailey, Gao, Jank, Lin, Licas, Viswanathan, *The Log Tail is Longer than You Think*, May 2008

<sup>&</sup>lt;sup>28</sup> Fox at 28.

<sup>&</sup>lt;sup>29</sup> Internet Retailer, *Top 500*, 2012 p. 105 ("The starting point for the data gathering was the rankings of *retailers' web traffic.*")

- SchreinersGardens.com in Salem, Oregon Sixty-five years ago, Schreiners Gardens opened its first flower store. Later it added a catalog and eventually a web store.
   Schreiners now exceeds \$1 million in remote sales. As a specialty store, it is highly unlikely it will ever make the top 1000 in web traffic.
- MissouriQuiltCo.com in Hamilton, Missouri This business opened a store in 2008 but soon "it soon became apparent that in a town of 1100 people it would be difficult to produce enough revenue to employ our parents and also make a decent profit. This was the impetus behind growing [their] business online."<sup>30</sup> After opening its online store, MissouriQuilt grew into the largest employer in Caldwell County. It has boosted local tourism as quilters from around the world come to meet the owners and take quilting lessons. MissouriQuilt does over \$1 million in sales. Again, as a specialty store, it did not make the top 1000 in web traffic.

For these reasons, it is difficult to give any credence whatever to the SBA report. In fact, sampling in Oregon alone, NetChoice found 60 small e-commerce businesses with over \$1 million that were overlooked in the SBA report.

The conclusion one must draw from this is that MFA is fundamentally flawed. Even the purported carve-out for small business would prove woefully inadequate – it would need to be at least \$15 million in annual sales, as we testified in 2012.

Once it is understood that MFA's approach is fundamentally costly, discriminatory, and potentially unconstitutional, the door is opened to consider other approaches.

#### There's a better way than MFA: Home Rule and Revenue Return

NetChoice accepted Chairman Goodlatte's challenge to develop alternatives to MFA.

Beginning with the Principles, and being especially mindful of the due process limitations on the states' power to force tax compliance burdens on out-of-state businesses, we have conceptualized the approach of Home Rule and Revenue Return, by which Congress could authorize states to collect taxes when their residents purchase from out-of-state sellers.

The central concept is a voluntary multi-state Compact that would establish clear rules for interstate purchases on which sales tax currently is not being collected. States participating in the Compact would realize sales tax on purchases their residents make from remote businesses located in other Compact states.

<sup>30</sup> http://MissouriQuiltCo.com/Content/AboutUs

This concept treats catalog, online, and brick-and-mortar sellers the same. Every business would use the tax rates and rules that apply where it is located – not where the customer resides. This approach involves no new complications, because most retail business already takes place this way. Using the tax rates and rules where the business is located is already the rule for all brick-and-mortar sales. When a customer from Maryland buys a tool at a hardware store in Virginia, the store clerk does not inquire what state and county the customer is from. The clerk simply rings up the sale and applies the local Virginia sales tax. This is also the existing rule for all intrastate catalog and online sales in 17 states representing over half the nation's population. Because of its inherent simplicity, both SSTP and MFA allow these states to retain this rule for intrastate sales by catalogs and websites, since trying to use the customer's residence as the source of tax rates and rules in each case would be too complex and expensive.

Unlike an origin-based system, which leaves tax money in the business's state even though the purchaser is from another state, the Home Rule and Revenue Return concept would distribute taxes received from out-of-state purchasers to their home states. This results in states receiving sales tax revenue from their residents' out-of-state purchases, without imposing massive new compliance burdens.

The table below summarizes how the Home Rule and Revenue Return concept meets each of the Committee's Principles. Details of the concept are more fully explained in the following section.

 $<sup>^{31}</sup>$  AR AZ CA IA IL MO NC OH OK PA RI TN TX UT VA VT WA (SSTP member states in bold)

Judiciary Committee Principles	Home Rule & Revenue Return
1. Tax Relief – Using the Internet should not create new or discriminatory taxes not faced in the offline world. No fresh precedent for other areas of interstate taxation by States.	<ul> <li>States can join a multi-state compact to collect and distribute sales tax on remote purchases where tax is not now being paid.</li> <li>Treats remote sellers and brick-and-mortar businesses the same – using tax rates and rules for where the business is located – not where the customer resides.</li> <li>Establishes national standard, preempting state laws that purport to authorize alternative means to go beyond physical presence for tax imposition.</li> <li>Creates no new or discriminatory tax burdens.</li> </ul>
<b>2. Tech Neutrality</b> – The tax compliance burden on online sellers should not be less, but neither should it be greater than for similarly situated offline businesses.	<ul> <li>Just like brick-and-mortar businesses, all online and catalog sellers file and pay taxes in states where they're located.</li> <li>All businesses are subject to sales tax audits only from those states where the business has a physical presence.</li> </ul>
3. No Regulation Without Representation – Those who would bear state taxation, regulation and compliance burdens should have direct recourse to protest unfair, unwise or discriminatory rates and enforcement.	<ul> <li>Businesses are accountable only to the states where they are located for tax payments and audits, and for court appearances.</li> <li>States seeking to bring businesses in other states into court must adjudicate in the business's home state or in federal district Court.</li> <li>States may quit the compact if new tax burdens exceed the benefits.</li> </ul>
<b>4. Simplicity</b> – So simple and compliance so inexpensive and reliable as to render a small business exemption unnecessary.	<ul> <li>Whether online or offline, small businesses pay sales tax the same way they do now: based on rates and rules of their home state. But now they would do this on sales to customers in all compact states.</li> <li>Simple and equal treatment: online and brick-and-mortar stores follow the tax regimes where they are located.</li> </ul>
5. Tax Competition – Governments should be encouraged to compete to keep tax rates low and American businesses should not be disadvantaged vis-a-vis foreign competitors.	<ul> <li>A business in a compact state must collect tax on sales to customers in other compact states.</li> <li>A compact state has incentive to keep its tax rates low, since high taxes may discourage business from locating there.</li> </ul>
6. States' Rights – States should be sovereign within their physical boundaries. Congress should not mandate that States impose any sales tax compliance burdens.	<ul> <li>States maintain control over tax burdens imposed on any business located in the state.</li> <li>Compact participation is decided by state legislatures, which can also decide to quit the compact if new tax burdens exceed the benefits.</li> </ul>
<b>7. Privacy Rights</b> – Sensitive customer data must be protected.	<ul> <li>Compact states must implement privacy and security protections for all personal data on customer purchases.</li> </ul>

#### Details of the Home Rule & Revenue Return Concept

- 1. Establish a multistate compact. New federal legislation would authorize a multistate compact (the "Compact") to enable collection of taxes on remote sales between sellers and purchasers in Compact states. A member state of the Compact would require its in-state businesses to collect and remit sales tax on sales to purchasers located in other Compact states.
- **2.** *Uniform national standard.* The federal legislation would point states to the Compact as the sole method for imposing tax on sales made by a business to purchasers located in states where the business has no physical presence. This legislation would codify the physical presence standard similar to HR 2992, which requires: an employee assigned to the state; services of an exclusive agent necessary to maintain the market in a state; or lease/ownership of tangible or real property in a state<sup>32</sup>. As in HR 2992, this physical presence standard would exclude *de minimis* presence of less than 15 days in a state during a taxable year, or presence to conduct limited or transient business activity.

A statutory physical presence standard would prevent states from attempting to impose sales tax liability based on advertising arrangements, commonly controlled groups, or other means to reach businesses that lack a physical presence in the taxing state. The Compact would be the only means for a state to impose sales tax liability on businesses without physical presence in that state.

**3.** State sovereignty and optional participation. Each state could choose whether to join the Compact. If a state joins, then businesses in that state would continue to apply the same tax rates and rules as before. In addition, a business in that state would also collect tax on sales to purchasers in other Compact states where the business does not have a physical presence. If a state chose not to join the Compact, businesses in that state would continue collecting sales tax on sales to purchasers in other states where the business also had a physical presence.

Each state, not the federal government, should determine the extent to which it wishes to rely on sales tax. Being faithful to this principle means respecting the sovereign rights of

21

<sup>&</sup>lt;sup>32</sup> HR 2992, "Business Activity Tax Simplification Act of 2013", August 2, 2013, with sponsors Mr. Sensenbrenner, Mr. Goodlatte, Mr. Scott of Virginia, Mr. Bachus, Mr. Chabot, Mr. Duncan, Mr. Jordan, Mr. Jones of North Carolina, and Mr. Hastings. http://thomas.loc.gov/cgi-bin/query/z?c113:H.R.2992:

those few states that have no sales tax. In allowing each state to decide whether it wishes to join the Compact, the concept respects this principle.

Neither fairness nor revenue generation justifies violating this principle. The argument that Internet businesses will move to jurisdictions with no sales tax is spurious. Businesses are free to move today, but we have not witnessed this phenomenon. Businesses select their jurisdiction for a host of reasons: quality of life; business incentives; income and property taxes; quality of work force; etc. For example, online seller NewEgg.com chose to base its operations in New Jersey, just 80 miles from tax-free Delaware. Amazon chose Seattle, when it could have chosen Portland, just a couple of hours to the south – in a state that has no sales tax.

**4.** *Home Jurisdiction.* Since the fundamental principle of the concept is that every business — whether brick-and-mortar, online, or catalog — will collect and file taxes in the state where it is located, the legislation must clearly define where a business is "located" for this purpose. Once a state joins the Compact, each business with a physical presence in that state would designate one principal place of business in the United States. This will be its "Home Jurisdiction." The designation could not be manipulated: the seller's Home Jurisdiction would be the Compact state in which its greatest number of employees works, per payroll tax records. The federal legislation would also describe instances where the "number of employees" would not be an appropriate measure, and prescribe methods to use, as alternative means of designating Home Jurisdiction, either the state where most physical assets are located or the state designated as the principal place of business for federal income tax purposes.

Federal legislation would also describe instances where the "number of employees" may not be an appropriate measure, and prescribe methods to use an alternative means of designating Base Jurisdiction, such as where most physical assets are located or the principal place of business for federal income tax purposes.

Home Jurisdiction is a proven method of taxation in multistate compacts. The International Fuel Tax Agreement<sup>33</sup> allows truckers to file in their "Base Jurisdiction" instead of filing taxes in every single state they drive through. Similarly, the European Union uses a similar

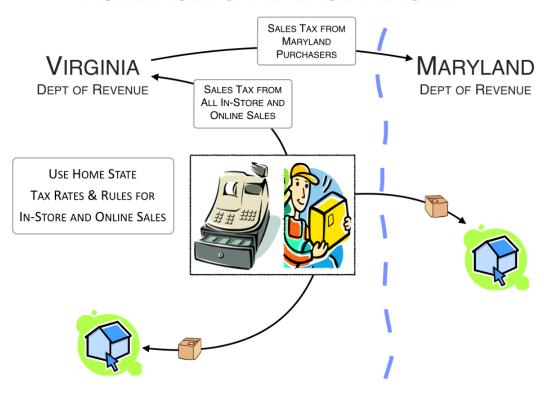
<sup>&</sup>lt;sup>33</sup> International Fuel Tax Association, Inc., http://www.iftach.org/

concept of "home jurisdiction" to tax out-of-country sales involving customers in other EU member states.<sup>34</sup>

Notwithstanding the Home Jurisdiction designated by a Compact state seller, a business must fulfill sales tax obligations for any state where it has a physical presence, according to the rates, rules, and tax holidays for those states, whenever selling to customers in those states.

Nothing in this concept would change the collection of sales tax at the cash register. Instore purchases will still collect at the store's local rates and rules. Home jurisdiction only apples to sellers in compact states selling into another compact states where the seller has no physical presence.

# Home Rule & Revenue Return



23

states where they have no physical presence. The EU and UK provide a home state rule for any remote seller below a per-nation sales threshold. At the same time, the EU and UK allow businesses to opt into collecting and remitting for a foreign state into which they sell. Under this system the majority of "distance sale" sellers collect and file VAT per their home state rules. http://ec.europa.eu/taxation\_customs/taxation/vat/how\_vat\_works/vat\_on\_services/

- **5.** One simple rule for tax collection. Once a business in a Compact state designates its Home Jurisdiction, it will be required to collect sales tax on any sale to residents of other Compact states where it has no physical presence, subject to these simple rules:
  - Regardless of where the purchaser resides, the business will use the tax rates, definitions of taxable goods and services, and tax holidays that apply to the Home Jurisdiction.
  - The business is required to file tax returns and remittances only in its Home Jurisdiction.
  - The business is subject to audits only by the state tax authorities of its Home Jurisdiction.

No state, whether or not it has joined the Compact, could demand payments or audits from a business that has no physical presence in that state.

**6.** One source of audit for remote sales. Every business will be subject to audit only by the state and local tax authorities where it has a physical presence, just as occurs now. A business that sells to customers in states where it has no physical presence would be subject to audit on those sales only by its Home Jurisdiction.

Under the Compact, no other Compact state may demand payments or audits, except by submitting those demands to the business's Home Jurisdiction. Businesses would therefore not be required to respond to audit demands from a state where the business has no physical presence or representation.

- **7.** Legal challenges to state tax authorities. Business taxpayers would have the right to enforce the Principles of the federal legislation in reply to legal demands from Compact states. For this purpose, business taxpayers would be entitled to use the federal district courts instead of litigating in the courts of the foreign state in question. This would require amendment of the Tax Injunction Act, 35 which presently bars federal court jurisdiction.
- **8.** No multiple taxation. Compact states would not impose additional tax liability on their residents who purchase from out-of-state sellers, beyond what is collected from the purchaser under the terms of the Compact. A purchaser would therefore not be liable for additional "use tax" if the out-of-state seller's Home Jurisdiction tax rate were less than the purchasers' state and local sales tax rate.

24

<sup>&</sup>lt;sup>35</sup> Compact states would also be required to waive their 10th and 11th amendment immunity for suits brought under the Tax Injunction Act.

**9.** *Privacy rights protected*. The federal legislation would require all Compact states to adopt privacy and data security safeguards for any purchaser information they collect in the course of administering sales tax filing or use tax reporting. For this purpose, the Payment Card Industry Data Security Standard could be required as a data security safeguard. In addition, the legislation would require independent audits of state data security practices.

For states that gather specific purchaser data for purposes of use tax compliance, the federal legislation would require that an independent clearinghouse first strip-off any data identifying the vendor and the goods or services that were purchased.

10. Revenue return. The federal legislation would require Compact states to periodically forward sales tax revenue paid by out-of-state purchasers to the states where the purchasers reside. This is similar to the clearinghouse approach that allocates tax revenue under the International Fuel Tax Agreement. Revenue return would require that businesses in Compact states include in their tax filing the amount of aggregate sales to purchasers from each state, but would not require reporting of the identities of purchasers or the nature of their purchases.

#### Conclusion

Quill's physical presence standard remains a principled and practical way to limit states' imposition of tax and audit burdens on out-of-state businesses. Congress should follow the principle of "first, do no harm" in considering whether to discard Quill. Should the Congress choose to exercise its power under the dormant Commerce Clause, it is essential that you observe the constraints on state taxing power imposed by the Due Process Clause.

The Home Rule and Revenue Return plan is an alternative to MFA that achieves this objective. It is sufficiently simple that small businesses may not need an exemption. All businesses would use the same tax rates and rules they already use today for in-state sales. There would be little new compliance burden. There would be no need to integrate new software to look up rates and rules for the other 45 taxing states. Retailers could continue filing tax returns and facing audits only in their home states. Such a system would fully comply with the Basic Principles on Remote Sales Taxes established by this Committee.